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SPECIAL REPORT

Alternative Tax Policies to Lower the U.S. Cost of Capital

by John B. Shoven

On May 1, 1990, the American Council for Capital Formation Center for Policy Research sponsored a seminar on "Business Taxes, Capital Costs, and Competitiveness." This roundtable discussion was the first of three seminars that the ACCF Center for Policy Research will host in 1990 as part of a special project on "Tax and Environmental Policies & U.S. Capital Costs." Center for Policy Research board member John B. Shoven, professor of economics at Stanford University, presented the results of his analysis of the impact of various business and individual tax reductions on U.S. capital costs at this seminar. Dr. Shoven's findings are summarized below. The symposium proceedings, including the full text of Dr. Shoven's paper, will be published by the Center for Policy Research as a special project monograph.

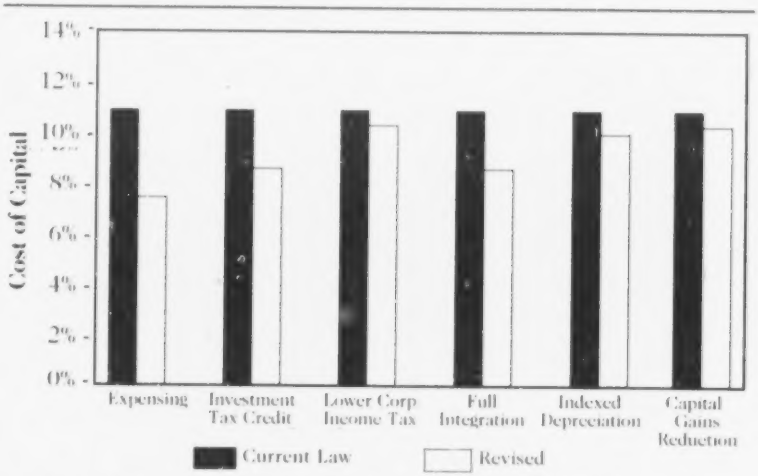
The level of net investment in the United States is low according to both historical and international comparisons. This fact is at the heart of the U.S. competitiveness problem. As a result of this low level of net investment, the real weekly earnings of U.S. workers have fallen over the past seventeen years and now stand at the same level as they did thirty years ago. One of the primary causes of the low rate of investment in our country is the high cost of capital.

The cost of capital depends on the terms demanded in financial markets for investments of varying riskiness and on the taxes that must be paid on the asset's returns. Three factors contribute to the cost of capital faced by investments in new equipment and structures: interest, risk premia, and taxes. In the United States today, the total cost of capital for a moderately risky investment in equipment or structures can easily exceed 12 percent.

A number of tax reforms can be examined in terms of their ability to lower the cost of capital. These include:

- the expensing of new investments
- a 7.5 percent investment tax credit
- lowering the corporate tax rate from 34 percent to 28 percent
- an integrated corporate and personal income tax structure
- the deduction of dividends from the corporate income tax
- a dividend gross-up plan

Figure 1: Impact of Selected Tax Code Revisions on the Cost of Capital for Investment in Equipment



Note: The examples above assume the investment is of moderate riskiness.

- indexing depreciation deductions
- lower capital gains taxes

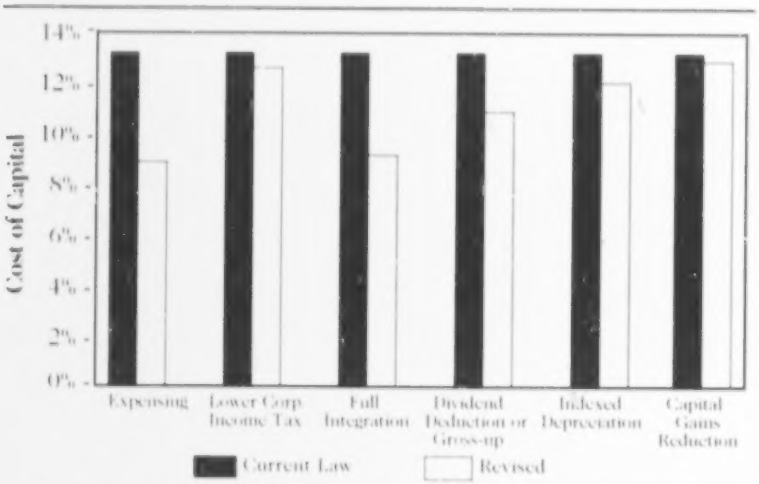
This analysis indicates that tax changes can bring about a significant reduction in the cost of capital. The effectiveness of any tax policy change in reducing capital costs is measured by how much the cost of capital declines as a result of the change.

The alternative reforms listed above vary in their effectiveness in lowering the cost of capital. Expensing, integration of the corporate and personal income tax structure, and a 7.5 percent investment tax credit each could lower the cost of capital by 20 to 30 percent (see Figures 1 and 2). *It appears that lowering the corporate tax rate would affect the cost of capital the least. The most effective option (per dollar of forgone revenue) may be an investment tax credit.*

Reducing capital gains tax rates from 28 to 20 percent would cause a noticeable reduction in the cost of capital, averaging 4.5 percent. In assessing the overall attractiveness of a capital gains tax reduction, however, one should also consider the revenue consequences, which this analysis does not examine. If a capital gains tax reduction resulted in little or no revenue loss, then its appeal would be enhanced even more.

In conclusion, this analysis demonstrates that tax policy changes could lower the U.S. cost of capital, which in turn would result in a higher level of investment and greater competitiveness of the U.S. economy. Because of the long-run beneficial effects for the U.S. economy, these policies deserve serious consideration.

Figure 2: Impact of Selected Tax Code Revisions on the Cost of Capital for Investment in Structures



Note: The examples above assume the investment is of moderate riskiness.

The ACCF Center for Policy Research is the education and research affiliate of the American Council for Capital Formation. Its mandate is to promote an understanding by the public of the importance of capital formation to the economy. For more information or to receive additional copies of this *Special Report*, please contact: ACCF Center for Policy Research, 1850 K Street, N.W., Suite 400, Washington, D.C., 20006, (202) 293-5811.